

force large incumbent firms to use as the basis of customer-specific bid prices. In other words, market entrants argue that the Commission should insist on a showing of costs, using FDC as the basis of the cost showing, which would inflate the bid prices incumbent firms would have to offer. Yet FDCs cannot serve as meaningful price floors because they have no consistent relationship with incremental costs, the economically meaningful basis for a price floor; nor can they be used as an implicit safeguard against predatory pricing concerns.⁹³

The net revenue test is far superior to fully distributed costing methods in a competitive market. A bid which satisfies the net revenue test will cover its own incremental costs plus make at least some contribution to overhead, thereby furthering the public interest by allowing the least-cost provider to offer its lowest price to customers. In contrast, an FDC method forces a regulated firm to include an arbitrary amount of contribution to overhead in its prices, even though no cost method exists to determine the "fair" or "proper" contribution level in the presence of joint and common costs.

In a competitive market, the market itself should be the true arbiter of the level of contribution to overhead from a given service or customer. Where competition exists, if FDC-based methods require prices in a bid to reflect too much overhead contribution, unregulated competitors can and will easily under-

93. The fact that FDC as a pricing standard may make firms like AT&T unable to compete (even if more efficient than their rivals) is not particularly novel. The risk of this occurrence was recognized in FCC Docket No. 18128, in which the Commission adopted a version of FDC as its pricing standard. AT&T, Long Lines Dept., Docket No. 18128, Memorandum Opinion and Order, 61 F.C.C.2d 587, 38 R.R.2d 1121 (1976), *review denied*, 67 F.C.C.2d 1195 (1978), *aff'd* 70 F.C.C.2d 616 (1978). See Besen & Woodbury, *Regulation, Deregulation, and Antitrust in the Telecommunications Industry*, 28 ANTITRUST BULL. 39 (1983). The lack of usefulness of FDC as a predation safeguard is discussed in detail in Larson, *Cost Allocations, Predation, and Cross-Subsidies in Telecommunications*, 14 J. CORP. L. 377 (1989). In addition, the ineffectiveness of FDC methods for determination of subsidies is well known in the mainstream economics literature. Several leading economists have discussed in detail the shortcomings of these methods as a means of detecting or preventing cross-subsidization. See, e.g., BONBRIGHT, DANIELSEN, & KAMERSCHEN, *supra* note 106, at 613-20; S. BROWN & D. SIBLEY, *THE THEORY OF PUBLIC UTILITY PRICING* 49 (1986); J. WENDERS, *THE ECONOMICS OF TELECOMMUNICATIONS* 174 (1987). See also Baumol, Koehn & Willig, *How Arbitrary is "Arbitrary"? — or, Toward the Deserved Demise of Full Cost Allocation*, PUB. UTIL. FORT., Sept. 3, 1987, at 16; Larson, *Costs, Allocations, and Regulatory Issues*, 5 TELEMATICS Apr. 1988, at 11.

cut the regulated firm's artificially high price, even if the unregulated firm is less efficient. This result is detrimental to the public and contrary to the Commission's stated goal of efficiency. On the other hand, use of the net revenue test is publicly beneficial because it promotes efficiency by all carriers by allowing the regulated carriers to emulate the pricing methods employed by unregulated carriers, and thus compete fairly in a competitive market.

III. MARKET POWER, PRICING FLEXIBILITY, AND REGULATION

In the *Competitive Carrier Proceedings*,⁹⁴ the FCC has distinguished between two classes of common carriers, dominant and non-dominant. Dominant carriers are those with market power.⁹⁵ Offerings of non-dominant carriers are presumptively lawful.⁹⁶ As a consequence of this distinction, customer-specific offerings of non-dominant carriers are presumptively lawful, whereas those of dominant carriers are presumptively unlawful. Thus a carrier's ability to offer customer-specific offerings depends only on whether or not the FCC decides it has market power.

A. Definition of Market Power

Market power is a firm's ability to charge prices in excess of competitive levels for significant periods of time.⁹⁷ It is the abil-

94. *Rates for Competitive Common Carrier Services*, 77 F.C.C.2d 308 (1979) [hereinafter *Competitive Common Carrier*; collectively, *Competitive Carrier Proceedings*]; *First Report and Order*, 85 F.C.C.2d 1, 52 R.R.2d 215 (1980) [hereinafter *First Report*]; *Further Notice of Proposed Rulemaking*, 84 F.C.C.2d 445 (1981); *Second Report and Order*, 91 F.C.C.2d 59, 52 R.R.2d 187 (1982), *recon. denied*, 93 F.C.C.2d 54 (1983) [hereinafter *Second Report*]; *Second Further Notice of Proposed Rulemaking*, 47 Fed. Reg. 17,308 (1982); *Third Report and Order*, 48 Fed. Reg. 46,791 (1983); *Third Further Notice of Proposed Rulemaking*, 47 Fed. Reg. 28,292 (1983); *Fourth Report and Order*, 95 F.C.C.2d 554, 46 R.R.2d 1219 (1983); *Fourth Further Notice of Proposed Rulemaking*, 96 F.C.C.2d 922 (1984); *Fifth Report and Order*, 98 F.C.C.2d 1191, 56 R.R.2d 1204 (1984); *Sixth Report and Order*, 99 F.C.C.2d 1020 (1985), *rev'd and remanded sub nom.*, *MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985).

95. *First Report*, *supra* note 94, at 10.

96. *Id.* at 31-33.

97. The definition of market power used by the U.S. Justice Department is "the ability of one or more firms profitably to maintain prices above competitive levels for a significant period of time" (monopoly power), or "the ability of a single buyer or

ity of a firm or group of firms acting jointly to raise prices above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded.⁹⁸ The concept of market power is the key to evaluating the lawfulness of customer-specific bids and to prescribing the way in which such pricing methods should be regulated. Economic thinking offers guidance in finding the appropriate role for regulation in such a situation. In addition, there are legal precedents for following these economic arguments.

A basic premise underlying the FCC's dichotomy between dominant and non-dominant carriers is an apparent belief that the mere fact a carrier is large with a high market share means that it possesses market power. Yet this is not necessarily the case, as the well-developed economics literature in this area indicates. While market share is related to market power, it is not necessarily a reliable indicator of such power.⁹⁹

Market share refers to the percentage of a market supplied by a particular firm during a specified time period. It is usually calculated in terms of the firm's share of the total market's sales revenues, volumes, or capacity (in physical terms).¹⁰⁰ On the other hand, market power is a firm's ability to raise prices above competitive levels without incurring a loss in sales that more than outweighs the benefits of the higher price.¹⁰¹ Thus, market share and market power are two distinct concepts, and the existence of high market share alone does not mean that a firm has market power.

According to the theory of contestable markets developed by Baumol, Panzar, Willig, and others, market power may be affected by either existing or potential competitors. For exam-

group of buyers to depress the price paid for a product to a level that is below the competitive price" (monopsony power). U.S. DEP'T OF JUSTICE, 1984 Merger Guidelines, 49 Fed. Reg. 26,823 (1984), Antitrust & Trade Reg. Rep. (BNA) No. 1169, at 8-1 (June 14, 1984). See generally Landes & Posner, *supra* note 12; Danielsen & Kamerschen, *A Methodological Study of Market Power and Market Shares in Intrastate Inter-LATA Telecommunications*, in TELECOMMUNICATIONS IN THE POST-DIVESTITURE ERA 135 (A. Danielsen & D. Kamerschen eds. 1986).

98. Landes & Posner, *supra* note 12, at 954.

99. E. SULLIVAN & J. HARRISON, UNDERSTANDING ANTITRUST AND ITS ECONOMIC IMPLICATIONS 220 (1988).

100. AMERICAN BAR ASSOCIATION ANTITRUST SECTION, MONOGRAPH No. 12, HORIZONTAL MERGERS: LAW AND POLICY 153-61 (1986).

101. SULLIVAN & HARRISON, *supra* note 99, at 219.

ple, a market that is currently served by a single established firm having a high market share may have low barriers to entry, meaning that much of the market could be served by potential entrants.¹⁰² For example, if a firm with 90% market share raised prices above competitive levels in this market, it could be overwhelmed by the expansion of existing firms and by new entrants to the market. In effect, the established firm with high market share would have no ability to raise prices above competitive levels.

A market is contestable when potential competitors, like currently active ones, can constrain market power. A market is perfectly contestable if prices adjust instantaneously¹⁰³ and there are no sunk costs of market entry.¹⁰⁴ The potential entrants use the prices charged by the incumbent firms before entry takes place as a basis for evaluating the profitability of entry.

Under this theory, even a firm with a natural monopoly may be forced by hit-and-run entry to price at the competitive level.¹⁰⁵ Thus, if a market is contestable, then even if there is only a single incumbent, sufficiently low barriers to entry may make public utility regulation or various antitrust concerns unnecessary. In fact, the costs and inefficiencies of such regulations may become an unnecessary burden on the public.¹⁰⁶

102. The definition of entry barriers is not critical to the analysis in this article, since all definitions show that market shares are not exclusive indicators of market power. See HORIZONTAL MERGERS: LAW AND POLICY, *supra* note 100 at 211-16; Ordover & Wall, *Proving Entry Barriers: A Practical Guide to the Economics of New Entry*, 2 ANTITRUST 12 (Winter 1988); J. TIROLE, *supra* note 32, at 305-11.

103. In a contestable market, no outside potential competitor can enter by cutting prices and then make money supplying quantities that do not exceed total market demands at those prices. The role of instantaneous price adjustment in this model is to constrain the market power of the incumbent by making profitable "hit and run" entry possible.

104. Sunk costs are those which cannot be eliminated in the short or intermediate run, even by ceasing production altogether. Note that sunk costs need not be fixed, and that fixed costs need not be sunk. BAUMOL, PANZAR, & WILLIG, *supra* note 53, at 280-82.

105. An informal definition of a natural monopoly is a single firm that can produce at lower cost than any collection of two or more firms. The complicated mathematical conditions on costs that must hold if natural monopoly is present are discussed in S.V. BERG & J. TSCHIRHART, NATURAL MONOPOLY REGULATION: PRINCIPLES AND PRACTICE 34-45 (1988).

106. The unifying literature in this area is BAUMOL, PANZAR & WILLIG, *supra* note 53. Related works are Baumol & Willig, *Contestability: Developments Since the Book*, 38 OXFORD ECON. PAPERS 9 (1986 Supp.). Surveys of the theory are contained

The long-distance market in which AT&T is a major participant may be workably contestable. A market is workably contestable if, for all practical purposes, it has incumbent firms (no matter how few) that are unable to raise their prices to gain any substantial advantage because of the threat of entry from potential rivals, notwithstanding market imperfections. If the long-distance market is workably contestable, then AT&T's market power is constrained by the threat of potential entrants as well as actual ones; if not, then AT&T may have enough market power to harm its rivals to the detriment of the public. However, there is little or no empirical research on the contestability of the long distance market, and this Article does not attempt to settle the question.¹⁰⁷

in G. REID, THEORIES OF INDUSTRIAL ORGANIZATION 141-71 (1987); Spence, *Contestable Markets and the Theory of Industry Structure: A Review Article*, 21 J. ECON. LITERATURE 981 (1983); Brock, *Contestable Markets and the Theory of Industry Structure: A Review Article*, 91 J. POL. ECON. 1055 (1983); Bailey & Friedlaender, *Market Structure and Multiproduct Industries*, 20 J. ECON. LITERATURE 1024 (1982). For a dissenting view, see Shepherd, "Contestability" vs. *Competition*, 74 AM. ECON. REV. 572 (1984).

107. The debate as to whether the long distance market is workably contestable is presented in J. BONBRIGHT, A. DANIELSEN, & D. KAMERSCHEN, *PRINCIPLES OF PUBLIC UTILITY RATES*, 598-602 (2d ed. 1988). See also Katz & Willig, *The Case for Freeing AT&T*, AEI J. ON GOV'T AND SOC'Y 43 (July/Aug. 1983); Kaserman & Mayo, *Long-distance Telecommunications Policy — Rationality on Hold*, PUB. UTIL. FORT., Dec. 22, 1988, at 18; Policy and Rules Concerning Rates for Dominant Carriers, 66 R.R.2d 372, Press Statement of Commissioner Dennis, FCC 87-313, at 2 (Mar. 16, 1989), stating: "The Commission first classified AT&T as dominant almost a decade ago. Telecommunications technology, regulation and competitors have changed markedly since then. Anecdotal evidence shows . . . that there are now markets in which AT&T is 'less than' dominant."

Dissenting views are contained in R. Simnett, *Contestable Markets and Telecommunications*, in *DEREGULATION AND DIVERSIFICATION OF UTILITIES* 127 (M.A. Crew ed. 1989) (the post-divestiture interLATA telephone business is not now competitive in its overall structure and is unlikely to become more so.); and Waverman, *U.S. Interexchange Competition*, in *CHANGING THE RULES: TECHNOLOGICAL CHANGE, INTERNATIONAL COMPETITION, AND REGULATION IN COMMUNICATIONS* 96-108 (R.W. CRANDELL AND K. FLAMM ED. 1989) (The interexchange market is not even imperfectly contestable). Yet even Simnett and Waverman support the argument that firms like AT&T do not have the ability to raise prices above competitive levels for any significant period of time. Simnett argues that the residence long distance market is not contestable and that the small business market is probably similar, whereas larger business users remain to be considered. Simnett, *supra*, at 141. Waverman argues that the interexchange market involves substantial entry barriers, principally the sunk capital that must be precommitted to service the market. Yet he also points out that besides AT&T, MCI, and U.S. Sprint, several regional networks capable of joining in national networks exist. These investments now represent re-

B. Market Power and the FCC's Competitive Carrier Proceedings

In the *Competitive Carrier Proceedings*,¹⁰⁸ the FCC determined that individual customer offerings are not inherently unlawful when offered by carriers who lack market power. The FCC recognized that these carriers, which it classified as non-dominant, employ unique pricing schemes in an effort to attract potential customers for their services. Moreover, the FCC acknowledged that the differences in rates to apparently similarly situated individual customers or classes of customers, which sometimes result from these innovative pricing plans, are "a normal response to competitive forces in the marketplace in which these carriers operate."¹⁰⁹ The FCC reasoned that competition, in the absence of market power, insures the availability of telecommunications services at reasonable prices.¹¹⁰ As a result, the FCC found that price differentiations of non-dominant carriers which reflect competitive forces at work are presumptively lawful.¹¹¹

Customer-specific offerings of non-dominant carriers are considered lawful because such carriers do not possess market power. The same logic should also apply to those carriers designated as dominant: customer-specific offerings of dominant carriers should be considered lawful when such carriers do not possess market power.

The *Competitive Carrier Proceedings* were instituted to permit the FCC to adjust its common carrier tariff and facilities authorization requirements for those carriers facing competition in the marketplace. In its *First Report*, the FCC established two classes of common carriers, dominant and non-dominant. The FCC reduced and streamlined the regulatory requirements for

sources that clearly diminish the market power that AT&T may have had in some interexchange markets. Waverman, *supra*, at 97.

108. *Competitive Carrier Proceedings*, *supra* note 94.

109. *Competitive Common Carrier*, *supra* note 94, at 337.

110. *First Report*, *supra* note 94, at 1-5, 52 R.R.2d at 215-19.

111. It should be pointed out here that the filings of such "non-dominant" carriers are only *prima facie* lawful. Such filings can be suspended or rejected if a petitioner rebuts the presumption with compelling evidence that there is high probability that the offering was unlawful and that the harm to competition outweighs any benefit to the public of having this service available. *First Report*, *supra* note 94, at 9, 52 R.R.2d at 228-29 (1980); *Competitive Common Carrier*, *supra* note 94, at 340.

the non-dominant carriers because such carriers by definition lacked market power, and hence lacked the ability to set prices in violation of the Act. As a result, the customer-specific offerings of non-dominant carriers were found to be presumptively lawful. Yet similar relief from regulatory scrutiny was withheld from AT&T and all carriers providing local exchange service because the FCC found that these carriers firmly controlled the telecommunications industry's "bottleneck" facilities, *i.e.*, the essential commodity or facility enabling them to impede new entrants.¹¹²

The present condition of the telecommunications industry no longer supports the conventional wisdom that dominant carriers, by virtue of their size alone (as measured by indicators like market share), have sufficient market power to injure emerging new competitors.¹¹³ The customer-specific bids of dominant carriers, like those of the so-called non-dominant carriers, should thus be presumed to be lawful.

As the FCC noted in the *Decreased Regulation Order*,¹¹⁴ the telecommunications industry today is quite different from the industry which existed in 1983. In that proceeding, the FCC found that, partly

because of the pro-competitive deregulation policies of the *Competitive Carrier*, *Computer II*, *Computer III*, and the *MTS/WATS Market Structure* proceedings, numerous new telecommunications suppliers were competing successfully with traditional dominant firms in providing the public with certain basic services and their substitutes. The FCC tentatively concluded that for some offerings, competition was sufficiently intense that dominant carriers appear to have little or no market power.¹¹⁵

Following the FCC's own reasoning, the customer-specific offerings of all carriers should be treated alike for services in which the so-called dominant carrier lacks the ability to set predatory prices.¹¹⁶ Accordingly, to the extent that the individual service offerings of non-dominant carriers are entitled to a presumption

112. *First Report*, *supra* note 94, at 20-21, 52 R.R.2d at 229-30.

113. See J. Haring & K. Levitz, *What Makes the Dominant Firm Dominant?* (FCC Office of Plans and Policy Working Paper Series No. 25, April 1989).

114. *Decreased Regulation Order*, *supra* note 67.

115. *Id.* at 646.

116. However, if there are economic linkages between a firm's monopoly markets and its competitive markets, there is a possibility of monopolistic leveraging. See Bowman, *Tying Arrangements and the Leverage Problem*, 67 YALE L.J. 19 (1957).

of lawfulness, the customer-specific offerings of dominant carriers that face significant competition should also be presumed lawful.

In summary, a firm's large market share may result solely from serving customers better than competitors, or it may stem from past economic conditions. Yet a carrier with a large market share may be unable to wield market power because actual or potential competitors constrain the carrier's prices at competitive levels. If that situation exists, as it does in the long distance market,¹¹⁷ the distinction between dominant and non-dominant carriers is anomalous. Moreover, the very need to offer services at other than tariff rates indicates the existence of a competitive market for certain customers. If this were not so, then a dominant carrier would merely assert its supposed market power without even considering the need to compete with the offerings of non-dominant carriers.

IV. COMPETITIVE NECESSITY AND THE DOMINANT/NON-DOMINANT DISTINCTION

In its *First Report*,¹¹⁸ the FCC distinguished between dominant and non-dominant carriers. The FCC reduced and streamlined the regulatory requirements for the non-dominant carriers because such carriers by definition lacked market power, and hence lacked the ability to set prices in violation of the Act. As a result, the customer-specific offerings of non-dominant carriers were found to be presumptively lawful. Yet similar relief was withheld from dominant carriers because the FCC found that those carriers firmly controlled the telecommunications industry's "bottleneck" facilities, *i.e.*, the essential services or resources which the carriers control exclusively.¹¹⁹

The FCC has repeatedly made it clear that the substantive requirements of Sections 201 and 202 of the Act apply equally to dominant and non-dominant carriers. In the Competitive Carrier Proceedings, the FCC emphasized that although it was relaxing regulatory procedures applicable to non-dominant

117. See BAUMOL, PANZAR, & WILLIG, *supra* note 53, at 351-56.

118. See *supra* note 94, at 20-21.

119. *Id.*

carriers, those carriers were in no way relieved of the substantive requirements of the Communications Act. The FCC stated:

We have not eliminated the requirements that rates be just, reasonable, and non-discriminatory. We have merely changed the method by which we will police that requirement. . . . [O]ur action today does not relieve non-dominant carriers from complying with the provisions of Sections 201-205 of the Act It merely modifies the method by which the Commission assures compliance with these requirements.¹²⁰

The FCC felt that competitive forces in the marketplace would in most instances insure a non-dominant carrier's compliance with the obligations imposed by Sections 201 and 202, thus warranting a presumption that a non-dominant carrier's rates are lawful. Nevertheless, the FCC recognized the potential for market failures and asserted that it would enforce Sections 201 and 202 of the Act as applied to non-dominant carriers through a complaint process.¹²¹

The Act does not create a double standard for determining the lawfulness of similar services. Single customer offerings of non-dominant carriers, like those of dominant carriers, are subject to claims of unlawfulness under the Act. The FCC has used the competitive necessity doctrine in dominant carrier offerings to determine the lawfulness of price differentials attributed to competition. Consequently, the competitive necessity doctrine should also be used to determine the lawfulness of individual customer offerings of both dominant and non-dominant carriers.

A. Asymmetric Regulation of Dominant and Non-dominant Carriers and the Public Interest

According to the FCC's dominant/non-dominant distinction, non-dominant carriers may make single customer offerings while dominant carriers may not. However, if there is significant competition in the long distance market, and thus no firm (dominant or non-dominant) has market power, there is no economic justification for distinguishing between dominant and non-dominant carriers. Indeed, such asymmetric treatment of firms and their allowed pricing behavior may be contrary to the

120. *First Report*, *supra* note 94, at 4-18, 52 R.R.2d at 218-28 (emphasis added).

121. *Second Report*, *supra* note 94, at 69-70, 52 R.R.2d at 195-96.

public interest because it creates perverse economic incentives for the firms.

By allowing only non-dominant carriers to make single customer offerings, the FCC banned dominant carriers from decreased prices. Prohibiting discounts prevents consumers from purchasing services at lower prices, even though the firms offering these services can still make a profit at the lower price. Therefore, allowing only the non-dominant carriers to make single customer offerings is not in the public interest. To proscribe pricing flexibility for the dominant carriers, but not for others, imposes significant costs on telephone company customers and offers no real counterbalancing benefits.

Regulators are often concerned that departures from the traditional regulatory practices of uniform tariffed rates charged by all carriers to all customers may not be in the public interest because customers not targeted for lower prices are disadvantaged by the carrier's ability to lower the prices for others. A closely-related concern is that pricing flexibility, in the form of single customer offerings, will lead to unduly discriminatory pricing between similarly-situated customers. Although both concerns are substantive, they must be considered in light of the alternative, which is to force the dominant carrier to lose business because it cannot price competitively.

Generally, pricing flexibility benefits all telephone customers if the following conditions are met:

- (1) Single customer offerings are used to obtain business that a telephone company would not normally obtain at the standard tariffed rate.
- (2) The additional business produced by offering prices below the tariffed rates contributes to covering the telephone company's overhead costs.

Pricing flexibility benefits a carrier's customers. It generates new business that not only pays for the additional costs it causes, but also pays for a portion of the telephone company's overhead. Overhead costs are thereby spread over a larger base of customers. Without pricing flexibility, there would be no new customers and the telephone company would have to cover its overhead by charging higher prices to its existing customers. Whenever the telephone company obtains new business to share overhead expenses, all its customers benefit, regardless of whether those customers have few or many competitive alterna-

tives. Thus, a policy that permits a carrier to discount its services and obtain business that it would not be able to obtain at the tariffed rates benefits all customers.

In addition to obstructing the flow of lower prices to customers, disparate treatment of dominant carriers encourages market entry by inefficient competitors. Furthermore, this policy may foster inefficient investment patterns. Large carriers may be able to exploit economies of scale to offer services at a lower price than other competitors. Thus, barring dominant carriers from offering services at lower, competitive prices thwarts the FCC's goal of promoting competition. In effect, efficient dominant carriers cannot pass their efficiencies on to the market. Entrants to the market then can have higher cost structures than the competitive optimum yet still make a profit, because the market is not truly competitive.

Asymmetric regulation of carriers would lead to cream-skimming and the erosion of the dominant carrier's customer base.¹²² As a result, prices would rise as the dominant carrier's customer base dwindled down to those who cost the most to serve and are the least attractive to competitors. Furthermore, in an asymmetric price regulation regime, dominant carriers like AT&T will have less incentive to invest in research and development to furnish innovative services at rational prices.

Asymmetric regulation is often supported on the grounds that a dominant carrier, like AT&T, is a natural monopoly, so asymmetric regulation is necessary to protect other competitors. But there is no evidence that AT&T is a natural monopoly. To be a natural monopoly, a firm must have a cost structure that meets the conditions of subadditivity. There is no empirical evidence that the cost structure of AT&T (or a RBOC) meets the conditions of subadditivity, *i.e.*, that such a firm will always be able to offer service at less cost to society than any multiple grouping of firms.¹²³

Regardless of whether the dominant player in this market is a natural monopoly, restricting it from engaging in customer-specific proposals does not serve the public interest. Even if the

122. See, e.g., J. Haring, *Implication of Asymmetric Regulation for Competition Policy Analysis* (FCC Office of Plans and Policy Working Paper Series, Dec. 1984).

123. See A. JACQUEMIN, *THE NEW INDUSTRIAL ORGANIZATION: MARKET FORCES AND STRATEGIC BEHAVIOR* 18-23 (1988).

dominant player were a natural monopoly, protecting new entrants only raises social costs and prolongs their exit (which must occur sooner or later if natural monopoly truly is present). On the other hand, if the dominant player is not a natural monopoly, then protecting new entrants from price competition distorts market shares away from efficient levels, again raising industry costs.¹²⁴

It is often feared that granting pricing flexibility to large carriers may be contrary to the public interest because it would allow them to cross-subsidize competitive services with revenues from less competitive services. A related concern is that such pricing flexibility will lead large carriers to set predatory prices which are anti-competitive. These worries are unfounded; cross-subsidization and predatory pricing are minimal concerns in public utility regulation.

Predatory pricing is unlikely to occur in long distance telecommunications. In the case of *Cargill v. Monfort of Colorado*,¹²⁵ the Court observed that a firm's possession of the financial resources necessary to absorb the losses of below-cost pricing over an extended period of time is not sufficient to support a claim of predatory pricing. Rather, the firm's share of market capacity and the barriers to entry after competitors have exited the market must also be considered. The Court offered the following reasons for exploring the market structure:

In order to succeed in a sustained campaign of predatory pricing, a predator must be able to absorb the market shares of its rivals once prices have been cut. If it cannot do so, its attempts at predation will presumably fail, because there will remain in the market sufficient demand for the competitors' goods at a higher price, and the competitors will not be driven out of business. . . . Courts should

124. It is difficult to measure cost characteristics to determine whether a telecommunications firm as large as AT&T or a RBOC is truly a natural monopoly. Measurement of economies of scale and scope and the econometric tests of subadditivity in the telecommunication industry's multiproduct environment are extremely complex technical exercises that have produced an unsettled literature. On this point, the jury is still out. A comprehensive review of this literature is in Kiss & Lefebvre, *Econometric Models of Telecommunications Firms*, *REVUE ECONOMIQUE*, Mar. 1987, at 307. The conclusions of the Kiss and Lefebvre article and their implications for telecommunications industry structure are summarized in BONBRIGHT, DANIELSEN & KAMERSCHEN, *supra* note 106, at 602-06.

125. 479 U.S. 104 (1986). The analysis of *Cargill v. Monfort of Colorado* in this section was prepared by attorney Warren Lavey.

not find allegations of predatory pricing credible when the alleged predator is incapable of successfully pursuing a predatory scheme. It is also important to examine the barriers to entry into the market, because "without barriers to entry it would presumably be impossible to maintain supracompetitive prices for an extended time." . . . In evaluating entry barriers in the context of a predatory-pricing claim, however, a court should focus on whether significant entry barriers would exist *after* the merged firm had eliminated some of its rivals, because at that point the remaining firms would begin to charge supracompetitive prices, and the barriers that existed during competitive conditions might well prove insignificant.¹²⁶

The Court's analysis of the market structure in this case led it to conclude that the resulting merged firm lacked the capacity necessary to pursue predatory pricing and that the record did not support the district court's finding of high barriers to entry.¹²⁷

After *Cargill*, a plaintiff must prove that the alleged predator has the capacity to serve most of the market and that there are high post-predation entry barriers.¹²⁸ But in the long distance market, post-predation entry barriers would not be high. A predatory scheme probably would leave the lines and switches of a bankrupt competitor in the same position as the deactivated plants in *Cargill* — facilities that could readily be reactivated by a new entrant, thereby suggesting low post-predation entry barriers. These low post-predation entry barriers should lead an antitrust court to find a low likelihood of predation.¹²⁹ Allowing a firm like AT&T to make customer-specific offerings, then, does not automatically open the door to predatory pricing. Since predatory pricing is unlikely in the long dis-

126. *Id.* at 119 n. 15 (quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 591 n. 15 (1986)) (emphasis in original).

127. *Id.*

128. Strictly speaking, a firm with limited capacity can still enjoy high profits if it is able to eliminate actual competition or deter potential competition.

129. In fact, Waverman has pointed out that it is unlikely that predation against any rival would prove to be advantageous for AT&T, since there is excess capacity already present in fiber-optic systems. He further points out that these sunk investments act as backstops preventing attempts at predatory abuse. Substantial capacity additions have taken place in the long distance market, principally through large investments in fiber-optic routes and networks by recent entrants in the market. Interexchange capacity in 1988 was between three to four times the capacity existing in 1981. Much of this additional capacity was added by what are known as "carriers' carriers," firms that provide interexchange capacity but do not retail that capacity to final customers, such as Fibretrak, Lightnet, and Electra. See Waverman, *supra* note 107, at 62.

tance market, asymmetric regulation is a dispensable protection against predatory pricing.

An explicit rejection of cross-subsidization did not appear in the case law until very recently.¹³⁰ In *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*,¹³¹ the Court held that a conspiracy to charge high prices in one market is not evidence of a conspiracy to engage in predatory pricing in another market. The court concluded that, first, conduct in one market has little bearing on conduct in another market because rational firms maximize profits independently in each separate market. Second, it concluded that high profits in one market do not suggest a willingness to engage in predatory conduct in another market. Both of these conclusions essentially reject the notion of cross-subsidization.

In *Clamp-All Corp. v. Cast Iron Soil Pipe Inst.*,¹³² the First Circuit also rejected a theory of cross-subsidization. In this case the plaintiff claimed that the defendants behaved unlawfully by agreeing to charge high prices on some products as a means of financing a below-cost pricing strategy. The First Circuit rejected this claim, stating:

[T]he only important element here for a court to examine at the request of a competitor is the low price. If that price is unlawfully low, if, for example, it is a predatory price, it does not ordinarily matter whether the money to pay for the resulting temporary loss comes from a bank account, a legacy, a lottery prize, or the proceeds of a price-fixing conspiracy in respect to another product; regardless of financing source, the practice would be unlawful. . . . We do not see how a dubious kind of "financing source" could, in and of itself, convert a lawful low price into an unlawful one.¹³³

Thus, the court rejected the notion that a high price in one market is necessarily evidence of predatory pricing in another market. Although *Clamp-All* involves antitrust and not public utility regulation, it has significant implications for customer-specific offerings, since the economic concepts in both situations are the same: the alleged source of financing of a predatory pricing strategy has no bearing on whether low prices are unlawfully

130. See Rasmussen & Glazer, *Antitrust Implications of Cases Rejecting Cross-Subsidization Arguments*, ANTITRUST, Fall 1988, at 28.

131. 475 U.S. 574 (1986), cert. denied, 481 U.S. 1029 (1987).

132. 851 F.2d 478 (1st Cir. 1988), cert. denied, 109 S. Ct. 789 (1989).

133. *Id.* at 485-86 (emphasis in original).

low, even if the source of financing is "high" prices paid by "captive" ratepayers with few or no service alternatives.

The *Matsushita* and *Clamp-All* cases essentially close doors opened in past cases involving AT&T. For example, in *Northeastern Tel. Co. v. AT&T*,¹³⁴ a supplier of telephone terminal equipment argued that AT&T engaged in predatory pricing and cross-subsidization by setting the price of its equipment below its fully distributed cost. The court determined that the relationship of price to incremental cost is the proper test of predatory pricing¹³⁵ and thereby rejected the plaintiff's argument that pricing below the fully distributed cost created anti-competitive cross-subsidization. The court explained:

Northeastern's argument in favor of the fully distributed cost test is based on a misunderstanding of the economic notion of subsidization. Northeastern seems to believe that whenever a product's price fails to cover fully distributed costs, the enterprise must subsidize that product's revenues with revenues earned elsewhere. But when the price of an item exceeds the costs directly attributable to its production, that is, when price exceeds marginal or average variable cost, no subsidy is necessary. On the contrary, any surplus can be used to defray the firm's non-allocable expenses.¹³⁶

Although the court rejected a reverse-subsidization argument that low prices in one market force the predator to raise them in another market, it did not use mainstream economic analysis. The defendant's low prices were found to be above "cost" (i.e., incremental cost) and thus not in need of some source of revenues for subsidies. The court implicitly accepted the concept of cross-subsidization by suggesting that subsidization would occur if prices were below cost. In contrast, *Matsushita* and *Clamp-All* represent a deeper economic analysis; they espouse the theory that a predatory pricing strategy must stand on its own as a "sound" strategic move.

B. Reasonable Discrimination and Undue Preference Under the Act and the Public Interest

From an economic viewpoint, when the price structure of a regulated firm is eroded by the presence of both joint and common costs and competitive pressures (as in the *Tariff No. 15*

134. 651 F.2d 76 (2d Cir. 1981), cert. denied, 455 U.S. 943 (1982).

135. *Id.* at 88.

136. *Id.* at 90.

market), it is not necessarily inappropriate for that firm to offer similar services at different prices. In fact, this type of pricing behavior more likely will lead to the most reasonable rates overall.

Absent competition, regulators can maintain a uniform relationship between rates and costs.¹³⁷ However, competitive entry into a market makes it impossible to set regulated rates that have some uniform relation to costs. Because of competition, customers may have different demand characteristics, while at the same time the cost to supply the same service to each of them may be equal. For instance, given equal costs of service, one customer may have competitive alternatives to choose from while the other does not. A regulated tariff rate will be acceptable to the customer without competitive alternatives. However, the other customer will desert the regulated utility if a discount is not provided. Competition thus leads customers with identical costs of service to pay different rates.

It is not necessarily against public policy for similar customers to pay different rates. Indeed, such rates would most likely be the ones that maximize the total contribution to overhead costs. In a competitive market, the maximization of total contribution to overhead all but requires customers to pay differential rates, with varying competitive alternatives, even though they may have similar costs of service.

Economists describe any situation where a seller charges similar customers different prices for the same product as "price discrimination."¹³⁸ For example, if Disneyland charges \$18 admission for adults but only \$12 for children, price discrimination has occurred. Price discrimination also occurs every time the same price is charged to two different customers, even though the costs of serving them differ. For example, a hamburger at a fast food restaurant with a full complement of toppings often carries the same price as a "plain" hamburger, even though the costs of providing these two dishes are different. "In most cases, price discrimination has little competitive significance."¹³⁹ Thus, from a strict economic viewpoint a rate is "discrimina-

137. For a discussion of rate-setting for public utilities, see BONBRIGHT, DANIELSEN, & KAMERSCHEN, *supra* note 106, at 514-44.

138. J. TIROLE, *supra* note 32, at 133-34.

139. R. BLAIR & D. KASERMAN, *ANTITRUST ECONOMICS* 258 (1985).

tory" (but not necessarily unlawful) if the same product is sold to different customers at different prices, regardless whether the cost of serving them is the same for each. Likewise, discrimination also takes place if the costs to serve various customers differ, but these customers are paying uniform tariffed rates.

Under the Act, price discrimination is unlawful only if it is undue:

It shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, classifications, regulations, facilities, or services for or in connection with like communication service, directly or indirectly, by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person, class of persons, or locality, or to subject any particular person, class of persons, or locality to any undue or unreasonable prejudice or disadvantage.¹⁴⁰

A customer-specific price discount is not undue price discrimination. On the one hand, to retain the business of the high-use customers a selective price discount is required, resulting in discriminatory rates according to the economic definition. On the other hand, to maintain rates that are related in a mechanical manner to costs can cause the incumbent carrier to lose business to rival firms which are not necessarily as efficient as the incumbent. It is strictly an empirical question which of selective price reductions or uniform rates is more efficient, but in general where open competition serves as an effective check on seller profits, it is efficient to distribute the burden of overhead recovery between less price-sensitive and more price-sensitive buyers.¹⁴¹

Absent regulation and the uniform tariff rates regulation normally requires, if a firm like AT&T attempted to engage in a truly discriminatory pricing policy, it would be undermined by competitors who could offer equivalent services at less than a discriminatory price.¹⁴² That some customers may end up accepting differing bids for identical services is not evidence that such pricing policies are in some way unduly discriminatory, even if the identical services have identical costs. Prices merely

140. 47 U.S.C. § 202(a) (1982).

141. See Frank, *When Are Price Differentials Discriminatory?*, 2 J. POL'Y ANALYSIS & MGMT. 238 (1983). See also, Schriber, *Price Discrimination: Creatively Coping with Competition*, PUB. UTIL. FORT., Sept. 1, 1988, at 11.

142. See Haring, *supra* note 122.

differ in the same way that prices in competitive markets differ, and for the same reason. Firms jockey for market position while attempting to cover operating costs and overhead, assessing market demand ("what the market will bear") as best they can. Customers seek competitive bids, and often must make their acceptances with imperfect information.¹⁴³ This leads to differential, but not necessarily unduly discriminatory prices. In fact, differential prices are observed in highly competitive markets such as the airline industry.¹⁴⁴

CONCLUSION

From an economic perspective, the dominant/non-dominant distinction is insignificant in the market for *Tariff No. 15* services, because no carrier has the market power necessary to make it a dominant carrier. The FCC has held that single customer offerings of non-dominant carriers are not inherently unlawful under the Act because they merely reflect the competitive forces at work in the marketplace. Since those same competitive forces have stripped the carriers designated as dominant of their market power, the individual customer offerings of dominant carriers should also be presumed lawful.

The substantive provisions of the Act apply equally to both dominant and non-dominant carriers, and thus the standards for assessing the lawfulness of single customer offerings of dominant and non-dominant carriers should be the same. The FCC has long recognized competitive necessity as a justification for rate differentials which were the results of efforts to meet a competitor's lower price. Under the competitive necessity doctrine, such discounts are neither unlawful nor unreasonably discriminatory if they are reasonably limited to customers to whom the competing offer is available, result in prices that recoup their costs (as measured by the net revenue test), and involve no discriminatory "cost shifting." Furthermore, the economics literature indicates that market share is an inaccurate measure of market power, suggesting that a different measure be used even if the domi-

143. The search costs of gathering the information required to obtain the best price may exceed the benefits from obtaining the best price. Thus, rational customers usually accept a price bid without a perfect knowledge of the market. This, of course, leads to price variation in the market that has nothing to do with price discrimination.

144. Frank, *supra* note 143, at 238.

nant/non-dominant dichotomy is implicitly retained by the Commission.

Allowing pricing flexibility for single customer offerings yields many benefits to the public. It encourages competition in the long distance market and hence encourages firms to be efficient in operation and innovative with respect to their service offerings. Furthermore, if firms like AT&T retain business through single customer offerings, then rates to all customers remain lower than they otherwise would have been, even if the discount is not offered directly to all customers. This would be true under rate-of-return regulation or under a price cap regulatory regime.

If concerns of predatory pricing and cross-subsidization are present, then the FCC's net revenue test constitutes a reasonable regulatory tool to address predatory pricing and cross-subsidization as long as the Areeda-Turner test used pervasively in anti-trust matters is adopted as a predation benchmark by regulators.

However, predation probably should be addressed in the courts, not in public utility regulation. A strict reliance on the courts offers benefits in the market for *Tariff No. 15* long distance services. Relying on the courts would allow large carriers more freedom to lower prices to the benefit of customers. Because it is easier for competitors to press their case for predation in regulatory proceedings than in court, the availability of such proceedings as a weapon to subvert competition looms large. By placing predation allegations in the courts, actions initiated in regulatory proceedings solely to impede competition are no longer available to plaintiffs not truly in earnest about addressing anticompetitive behavior.

With the net revenue test, the FCC has a practical tool with which to distinguish beneficial from harmful customer-specific offerings. If the additional revenues from a customer-specific offering exceed the additional costs it causes, then the public interest is served by permitting the offering. The net revenue test is a proxy for the economic concept of marginal cost pricing and is superior to a commonly proposed alternative, fully distributed cost test.

Thus, individual customer offerings of any carrier, dominant or non-dominant, are justified by the competitive necessity doctrine and should be found to be lawful under the Act. A

failure of administrative law to evaluate the legality of single customer offerings of all carriers under the competitive necessity doctrine would be detrimental to the public interest, as dominant carriers' customers without competitive alternatives would be charged higher rates and thus excluded from the benefits of a competitive market. The continuation of inefficient asymmetric regulation of the long distance market, particularly that segment of the market catering to high-use business customers, offers no benefits and imposes significant costs to the public. There is no need for long-term public policy to treat the *Tariff No. 15* Order merely as "TELPAC revisited."

MFS TELECOM, INC.

TARIFF F.C.C. NO. 2
1st Revised Page 41.2
Cancels Original Page 41.2

3.2 Customer Specific Contracts

The Company may provide any of the services offered under this tariff, or combinations of services, to Customers on a contractual basis. The terms and conditions of each contract offering are subject to the agreement of both the Customer and the Company. Such contract offerings will be made available to similarly situated Customers in substantially similar circumstances. Rates in other sections of this tariff do not apply to Customers who agree to contract arrangements, with respect to services within the scope of the contract. The rates provided under such contract offerings are listed in the attached appendices.

(T)

Rates and terms for services that the company offers to customers may vary depending on a number of factors, which may include:

(N)

- length of circuit(s)
- volume and/or term commitments
- varying equipment types and configurations
- type of service(s)
- cost differences (labor, taxes, fees paid to LEC for interconnection, etc.)
- customer-specific billing arrangements
- other miscellaneous fees and charges (e.g. rights of way charges, franchise fees and building rights of way costs, etc.)
- market conditions and/or competitive considerations
- availability of existing MFS facilities

★

★

★

★

★

★

★

★

★

★

★

★

★

↓

(35)

Issued: February 2, 1996

Effective: February 5, 1996

Valerie A. Wolff
Director - Tariff Analysis
1 Tower Lane, Suite 1600
Oakbrook Terrace, IL 60181

3. SERVICE DESCRIPTIONS (Cont'd)

3.3 FRAME RELAY SERVICE (FRS) (Cont'd)

3.3.6 Service Parameters including terms and rate elements are established on an Individual Contract Basis(ICBs). The ICBs are reflected in the tariff using the following variable service parameters.

(A) Contract Number

(B) Service Description:

L = Low Speed Access Of 56 Kbps
M = Medium Speed Access over 56 Kbps
up to, but not including 1.536 Mbps
H = High Speed Access of 1.536 Mbps
V = Very High Access over 1.536 Mbps
up to 6 Mbps

(C) Contract Terms

(D) Number of Customer Locations

(E) Service Class:

1 = On-Net Building
2 = On-Net City
3 = Off-Net Building
4 = Network to Network Interface

All Material On This Page Is New

Issued: February 2, 1996

Effective: February 5, 1996

Valerie A. Wolff
Director - Tariff Analysis
1 Tower Lane, Suite 1600
Oakbrook Terrace, IL 60181

3. SERVICE DESCRIPTIONS (Cont'd)

3.3 Frame Transport Service (FTS) (Cont'd)

3.3.6 (Cont'd)

(F) Service Delivery Zones

- 1 = Eastern Time Zone
- 2 = Central Time Zone
- 3 = Mountain Time Zone
- 4 = Pacific Time Zone

(G) Monthly Rate Package

3.3.7 Rates

Rates charges for the following services, which may include optional features and functions, will not exceed the amounts listed below.

3.3.7(A)

Port Speed Rate	MRR
Low Speed	\$165.00
Medium Speed	\$675.00
High Speed	\$1,440.00
Very High Speed	\$5,000.00
PVC Rate	MRR
Low Speed	\$352.00
Medium Speed	\$2,603.00
High Speed	\$5,479.00
Very High Speed	\$19,000.00

3.3.7(B)

FTS nonrecurring rate is \$1,000.00 per site

All Material On This Page Is New

Issued: February 2, 1996

Effective: February 5, 1996

Valerie A. Wolff
Director - Tariff Analysis
1 Tower Lane, Suite 1600
Oakbrook Terrace, IL 60181

APPENDIX H

LISTING OF ALL EFFECTIVE CONTRACT ARRANGEMENTS

AS OF 4/27/95

<u>Contract</u> <u>Number</u> <u>State</u>	<u>Service</u> <u>Description</u>	<u>Rate</u>	
		<u>Package</u>	
		<u>Monthly</u>	<u>Non-Recurring</u>
002400 TX	High Cap Service, Very High Cap Service	\$2,000.00	\$150.00
002401 TX	High Cap Service .	\$600.00	\$500.00
002402 TX	Low Speed Service	\$95.00	\$200.00
002403 TX	High Cap Service	\$1,230.00	\$1,950.00
002404 TX	Low Speed Service	\$1,900.00	\$8,400.00
002405 TX	High Cap Hub	\$2,565.00	\$5,023.00
002406 TX	Very High Cap Hub	\$6,881.00	\$6,100.00
002407 TX	Very High Cap Service	\$1,800.00	\$800.00
002408 TX	Very High Cap Mux	\$2,000.00	\$0.00
002409 TX	High Cap Service	\$340.00	\$5,510.00
002410 TX	Low Speed Service	\$900.00	\$925.00
002411 TX	High Cap Service	\$7,642.00	\$7,800.00
002412 TX	High Cap Hub	\$4,477.00	\$4,600.00
002413 TX	Very High Cap Service	\$11,849.00	\$7,406.00
002414 TX	Very High Cap Mux	\$1,150.00	\$150.00
002415 TX	Low Speed Service	\$525.00	\$2,450.00
002416 TX	High Cap Service	\$1,500.00	\$0.00
002417 TX	Video Service	\$950.00	\$1,400.00
002418 TX	Low Speed Service, High Cap Service	\$458.00	\$1,650.00
002419 TX	High Cap Service	\$300.00	\$1,000.00
002420 TX	High Cap Service	\$350.00	\$1,143.00
002421 TX	High Cap Service	\$1,507.00	\$2,300.00
002422 TX	Low Speed Service	\$125.00	\$500.00
002423 TX	Low Speed Service, High Cap Service	\$1,080.00	\$300.00

All Material On This Page Is New

Issued July 12, 1995

Effective July 13, 1995

Valerie A. Wolff
Director - Tariff Analysis
1 Tower Lane, Suite 1600
Oakbrook Terrace, IL 60181

APPENDIX H

LISTING OF ALL EFFECTIVE CONTRACT ARRANGEMENTS

AS OF 4/27/95

<u>Contract</u> <u>Number</u> <u>State</u>	<u>Service</u> <u>Description</u>	<u>Rate</u> <u>Package</u>	
		<u>Monthly</u>	<u>Non-Recurring</u>
002446 TX	High Cap Service	\$300.00	\$1,050.00
002447 TX	Very High Cap Hub	\$1,900.00	\$0.00
002448 TX	High Cap Service	\$275.00	\$0.00
002449 TX	Low Speed Service, High Cap Service	\$265.00	\$265.00
002450 TX	High Cap Service	\$600.00	\$1,000.00
002451 TX	Low Speed Service	\$210.00	\$0.00
002452 TX	High Cap Service	\$1,275.00	\$245.00
002453 TX	High Cap Hub, High Cap Dacs	\$5,163.12	\$4,709.00
002454 TX	Low Speed Service	\$1,382.50	\$400.00
002455 TX	High Cap Service	\$450.00	\$0.00
002456 TX	Low Speed Service, High Cap Service	\$1,723.50	\$1,100.00
002457 TX	High Cap Hub	\$2,355.00	\$3,654.00
002458 TX	High Cap Service	\$355.00	\$100.00
002459 TX	Low Speed Service	\$182.00	\$402.00
002460 TX	High Cap Service	\$1,032.00	\$0.00
002461 TX	High Cap Service	\$4,375.00	\$4,325.00
002462 TX	Very High Cap Service	\$5,000.00	\$0.00
002463 TX	High Cap Service	\$1,330.00	\$900.00
002464 TX	Low Speed Service	\$270.00	\$750.00
002465 TX	High Cap Service	\$582.00	\$200.00
002466 TX	Low Speed Service	\$460.00	\$0.00
002467 TX	High Cap Service	\$200.00	\$0.00
002468 TX	Very High Cap Hub	\$3,560.00	\$5,219.00

All Material On This Page Is New

Issued July 12, 1995

Effective July 13, 1995

Valerie A. Wolff
Director - Tariff Analysis
1 Tower Lane, Suite 1600
Oakbrook Terrace, IL 60181